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CHARLES ELMORE

IN THE

Supreme Court of the United States

OCTOBER TERM, 1940.

NO. 371.

ESTATE OF ANNA M. KELLER, PIUS P. KELLER and MARCELLA V. KELLER, Executors,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

BRIEF FOR PETITIONERS.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

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OPINIONS BELOW.

The opinion of the Board of Tax Appeals is reported in 39 B. T. A. 1047, and appears at pages 19 to 36 of the Record. The Opinion of the Circuit Court of Appeals for the Third Circuit (Clark, C. J.) is reported in 113 F. 2d (Advance Reports No. 5) 833, and appears at pages 71 to 77 of the Record.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered on May 28, 1940. No petition for rehearing was filed. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, 28 U. S. C. A., §347 (a). The petition for writ of certiorari was filed on August 23, 1940 and the writ was granted October 14, 1940 (R. 78).

QUESTION PRESENTED.

The Exemption from Estate Taxation Given to a Limited Amount of Life Insurance by Section 302 (g) of the Revenue Act of 1926, as Amended, Is Not Affected by an Insurance Company's Requiring the Taking Out of a Separate Annuity Contract as a Condition Precedent to the Issuance of a Standard Form Life Insurance Contract.

STATUTE AND REGULATIONS INVOLVED.

The pertinent statutory provisions and Regulations will be found in the Appendix, *infra,* pp. 36 and 37.

STATEMENT OF THE CASE.

This proceeding was initiated when petitioners filed a petition with the United States Board of Tax Appeals for a redetermination of a deficiency which the Commissioner of Internal Revenue had determined to be due from petitioners as additional estate tax.

THE QUESTION INVOLVED.

The question presented by the record is one of exemption from estate taxation, viz: Upon the death of a decedent who in her lifetime executed on the same day a single premium life insurance contract on the company's standard form and a single premium annuity contract also on the company's standard form; is the amount (being less than $40,000) received by the life insurance beneficiary, solely on the life insurance policy, "insurance" as that term is used in Section 302 (g) of the Revenue Act as amended, and accordingly exempt from estate taxation and excludible from decedent's gross estate?

The Board of Tax Appeals reversed the Commissioner and held that the amount was life insurance and that there was no deficiency in estate tax. The Board's Findings of Fact will be found in the Record, pp. 9-18 and the Opinion, pp. 19-36.

The United States Circuit Court of Appeals for the Third Circuit reversed the Board of Tax Appeals. (R. 71-77.)

THE FACTS FOUND BY THE TAX BOARD.

The facts as found by the Board of Tax Appeals are substantially as follows (R. 10-18):

Petitioners are the executors of the estate of Anna M. Keller, deceased. The decedent died March 28, 1936. (R. 10-11.)

(a) *The Annuity Contract.*

On December 31, 1934, the decedent, at the age of 75, executed a contract with the Equitable Life Assurance Society of the United States, sometimes hereinafter referred to as the insurance company. The contract is designated "Life Annuity. Single Premium. Non-Participating" and provides for the payment of a single premium of $3,258.20 to the insurance company in consideration for semi-annual annuity income payments of $195.42 by the insurance company to the annuitant during her lifetime. The contract was on the regular standard form used by the insurance company for writing annuity contracts, and among other things provided that "this agreement, and the application therefor, a copy of which is endorsed hereon or attached hereto, constitute the entire contract between the parties." (R. 10-11; Exhibit "C.")

(b) *The Life Insurance Contract.*

On the same day that the annuity contract was executed, the decedent also executed a policy or contract with the insurance company for the face amount of $20,000 which was designated as "Single Premium Life Policy. Insurance Payable at Death. Single Premium. Annual Dividends." The policy was on the regular standard form used by the insurance company for writ-

ing life insurance policies. This insurance was granted in consideration of the payment in advance to the Society of a single premium of Seventeen thousand nine hundred forty-one and 80/100 Dollars. (R. 11-12; Exhibit "D.") The policy named decedent's daughter as the beneficiary.

This policy also contained provisions relating to assignments, change of beneficiary, policy years, age and self-destruction. There was a provision captioned "The Contract" which provided as follows (R. 12-13): "This policy, and the application therefor, a copy of which is endorsed hereon or securely attached hereto, constitute the entire contract between the parties. * * *." The policy also contained a "Table of Loan and Cash Surrender Values for each $1,000 of Face Amount."

(c) *Company's Risk Not Eliminated on Insurance Contract.*

The company accepted in lieu of a medical examination the issuance of the life annuity contract, through which the company reduced but did not entirely eliminate its risk against loss due to premature death. (R. 14.) The insurance company would not have issued the insurance policy to the insured at her attained age of 75 years without issuing a life annuity contract in conjunction with the insurance policy but in computing the single premium paid for the life insurance contract, no adjustment was made for the amount received as a premium for the annuity contract. The consideration charged for the annuity contract would have been the same even if no life insurance had been purchased at the time and the decedent could have obtained the annuity contract without the insurance policy, in which case the annuity would have been identically the same

as in the annuity contract which was issued to the decedent. The requirement of the annuity contract as a condition precedent to the issuance of the insurance policy was due to the amount of risk involved, namely, the difference between the consideration and the death benefit. (R. 14.)

The total consideration paid by the decedent to the insurance company for the two contracts amounted to 106 percent of the face amount of the insurance policy or $21,200, which was $1,200 in excess of the face amount of the insurance policy. The name given to the $1,200 by the insurance company is "loading" and is for the purpose of paying commissions to the general agent and the special agent and for premium taxes. The actual expense exclusive of any profit and general overhead expense of the insurance company in issuing the two contracts in question was $1,475.97.

The above total charge of 106 percent on this type of contracts was later found to be unprofitable, at which time the charge was increased by the insurance company to 110 percent, and still later the issuance of an insurance policy like the one in question was made conditional upon a medical examination. (R. 14-15.)

The insurance company at all times treated the two contracts entered into with the decedent on December 31, 1934, as two separate transactions rather than as one transaction. (R. 15.) The company in its reports to the State Commissioner of Insurance listed the contracts separately—one under the life insurance group and the other under the annuity group. (R. 15-16.)

(d) *No Contemplation of Death.*

The principal cause of decedent's death was cerebral hemorrhage of one-half day duration. Up until the time of her last illness the decedent had enjoyed excellent health, had been remarkably free from any illnesses or disabilities, had been especially active for one of her years, enjoyed life and never expressed any expectancy of dying, nor mentioned death. Her mother and her grandmother were both in their nineties when they died. (R. 18.)

TAX BOARD HOLDS AMOUNT PAID IS INSURANCE.

The Commissioner included the proceeds of the life insurance in decedent's gross estate, claiming the entire transaction represented a transfer made to take effect at or after death, in accordance with the provisions of Section 803, Revenue Act of 1932, which amended Section 302 (c); Revenue Act of 1926, and imposed a deficiency in estate tax of $3,243.64. (R. 6-7.) The Board of Tax Appeals reversed this determination, holding that the proceeds of the life insurance is not includible in the decedent's gross estate as a transfer made in contemplation of death, or otherwise, and that the amount so paid represents "insurance under policies taken out by the decedent upon her own life" as that term is used in Section 302 (g) of the Revenue Act of 1926, as amended. (R. 26.) The Circuit Court of Appeals reversed the decision of the Board of Tax Appeals. (R. 76.)

SPECIFICATION OF ERRORS.

1. The Circuit Court of Appeals erred in reversing the judgment of the Board of Tax Appeals, and in reinstating an estate tax deficiency of $3,243.64.

2. The Circuit Court of Appeals erred in holding that petitioner was not entitled to deduct the proceeds of the life insurance policy from the decedent's gross estate.

3. The Circuit Court of Appeals erred in failing to give proper effect to Section 302 (g) of the Revenue Act of 1926, as amended (U. S. C. A. Title 26, Section 411), and Article 25 of Regulation 80 (1937 Ed.), which exempts from estate taxation the $20,030.43 proceeds of the life insurance policy taken out by the decedent on her own life and paid to decedent's daughter as beneficiary, inasmuch as decedent had no other life insurance.

4. The Circuit Court of Appeals erred in not accepting the following issues of fact resolved by the Board of Tax Appeals which were sustained by substantial evidence:

(a) The fact found by the Board of Tax Appeals that the issuance of the annuity policy reduced *but did not eliminate the company's risk* against loss due to premature death. (R. 14-15.)

(b) The fact found by the Board of Tax Appeals that decedent was not in contemplation of death when she took out the policy in question. (R. 9.)

(c) The fact found by the Board of Tax Appeals that the proceeds paid by the company to the

beneficiary of the policy was "insurance". (R. 18.)

5. The Circuit Court erred in ignoring the legal and contractual aspects of the life insurance contract, and in only considering possible *economic* effects of the two contracts. (Opinion, R. 74-75.)

6. The Circuit Court of Appeals erred in concluding "the Congress used the word 'insurance' with the economic rather than the purely contractual aspects of the term in mind." (Opinion, R. 75.)

SUMMARY OF ARGUMENT.

The life insurance policy involved in this case is as complete in and of itself as any contract of life insurance could be. It is conceded on all sides that were this contract the only one executed between the decedent and the company, it would be unquestionably a contract of life insurance and the $20,030.43 paid to the beneficiary on decedent's death would clearly represent "insurance" as the term is used in Section 302 (g) of the Revenue Act of 1926, as amended, and would therefore not be included in decedent's gross estate.

However, the Commissioner claims that this insurance contract cannot be considered as a contract of life insurance because it was written in conjunction or simultaneously with another separate contract. This other contract was an annuity policy. This annuity policy is also complete in and of itself, as much as any annuity could be.

It is conceded by both sides that because of the decedent's age, she would not have been issued the life insurance contract had she not taken out the annuity contract, and that upon her taking out both contracts no medical examination was required (R. 18).

Petitioners contend that the taking out of the annuity policy was required by the company as a condition precedent to issuing the insurance policy but that once this condition precedent was complied with, the two policies thenceforth were separate, distinct, independent contracts, and that this appears from their context, from the intention of the parties, and from the manner in which each policy and the premiums received thereunder were treated by the insurance company. Petitioners also contend, and the Tax Board so found (R. 14), that the company's requirement of the annuity as a condition precedent for issuing the life insurance was for the purpose of reducing the company's risk on the life insurance policy but that it did not eliminate said risk.

The Tax Board has found the facts in accordance with petitioners' contentions; and as these facts are supported by substantial evidence, the Appellate Court must accept them as resolved by the Tax Board.

Accordingly the proceeds of the life insurance policy paid to the beneficiary represent "insurance" as that term is used in Section 302 (g) of the 1926 Revenue Act, as amended, and they are excludible from decedent's gross estate.

ARGUMENT.

POINT I.

The Insurance and the Annuity Policies Were Separate Contracts, Neither Being Merged in the Other, and Each Retaining Its Insurance and Annuity Features Respectively, Despite the Fact That Both Contracts May Be Considered to Have Been Applied for in Connection With One Transaction.

Although the issuance of the respective life insurance and annuity contracts may be considered as constituting one transaction and the separate policies may therefore be construed in relation to each other, they cannot be considered as being merged into one single indivisible contract, nor do they lose their separate and distinct contractual features. A single transaction may often consist of two or more entirely separate, distinct and independent formal contracts. A common example is the single transaction between a mortgagor and a mortgagee where both a mortgage and a bond are given as security for the money loaned. Although the mortgage and the bond are issued in conjunction with each other and form part of a single transaction, they do not lose their separate contractual attributes and cannot be merged into one instrument, and even if the mortgage should prove worthless because of a flaw in the title or for some other reason, the bond would still remain a separate contract upon which the mortgagee could seek to recover the amount due.

But the two policies in the case at bar are even more separate, independent and severable contracts than the above illustration. Whereas the extinguish-

ment of all debt, whether accomplished by resort to the mortgage or to the bond, would cause the other instrument to become null and void, the life insurance policy in the case at bar could be surrendered for its cash surrender value and thus be terminated without in any way affecting the annuity contract any more than if the life insurance had never been issued.

Williston, On Contracts, 1936 Ed. Vol. III p. 1801 in the chapter on general rules for interpretation, or construction of contracts, *section 628* states:

> "* * * Even where a writing does not refer to another writing, if such other writing was made as part of the same transaction, the two should be construed together. It is usually said that the two writings together form one contract. Though this is generally true, it is not always accurate, even though the several writings are part of the same bargain. Where one of the writings is a formal document it cannot be incorporated in an ordinary writing. *A note and a mortgage to secure it are not strictly one contract,* though doubtless each is to be construed in connection with the other in order to determine its meaning. * * *" (R. 21.) [Italics ours.]

It is difficult to imagine two contracts, forming one transaction, more independent and severable both in form and fact than the two policies in question. Both were written on the respective regular standard forms (R. 11) and each was based on the mortality table customarily used in writing life and annuity policies, respectively. (R. 16). Neither contract contains any reference, directly or indirectly, to the other, but on the contrary, each provides that the agreement and the respective applications therefor "constitute the entire contract between the parties" (R. 11, 12). The insured

could exercise her rights under the life insurance contract irrespective of the existence of the annuity contract, and vice versa. She had the right to surrender the life policy for its cash value and thus terminate it, as well as the right to borrow upon it or assign it (R. 12, 13). Either the life insurance or the annuity policy could be sued on and enforced by itself.

Not only are the policies separate and distinct contracts according to their form, but they were so looked upon and so treated by the parties executing them.

Guy T. Helvering, Commissioner of Internal Revenue, v. Edyth LeGierse et al., 110 Fed. (2d) 734 (Second Circuit) (1940). This case involves practically identical policies and the same legal question as the case at bar. In the Circuit Court's opinion, which conflicts with that of the case at bar, the Court said (p. 735):

> "* * * Here the undertakings of the insurance company were obviously intended to be separable and independent. A separate application was made for each policy, a separate consideration paid for each, neither policy made reference to the other, and either could have been assigned, and the life policy could have been surrendered, without affecting the insurance company's obligations under the other. In these respects the situation is unlike that presented in *Old Colony Trust Co. v. Commissioner*, 102 F. (2d) 380 (C. C. A. 1) upon which the petitioner strongly relies. In substance as well as in form the policies issued to Mrs. LeGierse were independent contracts. In the life policy she took out insurance upon her life which is squarely within the exemption granted by the statute. The fact that she could not have gotten that policy unless she had also bought an annuity contract does not change the character of what she got."

The insurance company at all times treated the two contracts as two separate transactions and instruments instead of as one. (R. 15). Both on the company's records and in their reports, required by law, to the Superintendent of Insurance of the State of New York, the proceeds and liability with respect to the life insurance policy were included in their life insurance records and reports, and those relating to the annuity policy, in their annuity records and reports. Even in computing the amount of the premium to be charged for the policies, the computation for each was made without reference to the other, and each was on the same basis as if the other policy had not been taken out. (R. 15, 16).

Although it is conceded that because of the age of the insured the insurance company required the taking out of the annuity contract before it would issue the life insurance policy, this, as the Board of Tax Appeals found as a fact (R. 14), was merely a condition precedent imposed by the company for the purpose of reducing but not eliminating its risk. But once this condition precedent was complied with, the insurance policy became just as much a life insurance contract as any other policy issued on the same standard form.

Insurance companies have a right to require certain reasonable conditions precedent before they will issue a certain type of policy, but once this condition precedent is complied with the contract must be interpreted in accordance with what it actually is. For example, must insurance companies, especially in Pennsylvania, do not like to write Workmen's Compensation policies, and before writing them require the concern desiring such a policy to also take out with the company a Public Liability policy, in an amount large enough to make it worth while for the company to write the Compensation policy. Certainly it could not be claimed that because

the insurance company required the two policies to be taken out simultaneously, and because unless the Liability policy is taken out, they would not issue the Compensation policy, that therefore, because the two policies are issued as one transaction, each policy loses its separate characteristics, and the respective Liability and Compensation policies become merged into a single indivisible contract, or that the premiums paid for the two policies are to be considered as one lump sum.

Another example of a condition precedent required by insurance companies is in that type of policy designated as "Salary Saving" life insurance. This type will not be issued to less than 30 appl. ants and it is issued in face amounts up to $5,000 without the requirement of a medical examination. But if one individual applies for such a policy, the insurance company demands 29 additional similar policies from 29 other individuals before writing such a policy. However, once this condition precedent is met and 30 applications are received and the policies are written simultaneously or as one transaction, thenceforth each of the 30 policies are unquestionably separate, distinct, individual life insurance contracts issued to the 30 respective applicants.

The Board of Tax Appeals, in disposing of this point, says (R. 24):

> "* * * It seems to us that the situation is simply this: Even assuming that Mrs. Keller did not want to purchase an annuity (and we have no evidence to that effect) and only did so because she had to do it to secure the life insurance policy which she did want, nevertheless when the purchase was complete she owned two contracts and we have no cause to say that her life insurance policy was not life insurance merely because she had to purchase an

annuity policy along with it. We are cited to no authority which would compel any such holding."

Legg v. St. John, 296 U. S. 489. The Board of Tax Appeals in citing this case, states as follows (R. 22):

"In Legg v. St. John, supra, the question before the Supreme Court was whether Legg, a voluntary bankrupt, or his trustee was the person entitled to certain future monthly disability benefits payable under a contract entered into between Legg and an insurance company before the adjudication. Several years prior to the adjudication Legg took out a life insurance policy under which the company agreed, in consideration for a stated annual premium, to pay a certain amount upon his death. By a supplementary contract issued on the same day and attached to the policy, the company, in consideration for an additional annual premium of a stated amount, agreed to pay a monthly benefit of $174.52 upon due proof of total and permanent disability, which latter event happened several years before the adjudication. In holding that the disability benefits were payable to the trustee and not to the bankrupt, Mr. Justice Brandeis in the course of his opinion said:

'Second. The fact that the disability benefits are provided for in a "Supplementary Contract" issued on the same day as the policy and physically attached thereto does not make them life insurance. The life policy and the contract were executed as distinct instruments. The "Supplementary Contract" was to operate for some purposes as if a part of the life policy. But for all other purposes it is a separate obligation. The hazards covered by the two instruments are obviously different. The bene-

ficiaries differ also. The payment under the life policy was to be made to the wife; the disability benefits are to be paid to Legg himself. A separate and different premium was exacted for the obligations assumed in each instrument. It was provided that forfeiture of the life policy would terminate all rights arising from disability; but the supplementary contract could be terminated by Legg without affecting otherwise his life policy.' "

The Seefurth Service is a standard work extensively used by insurance companies as an acknowledged authority on insurance law and taxation. This Service, on page 21 of the 1937 Reference Volume, declares as follows:

"We have been informed of cases where the internal revenue department has taken the position that the $40,000 insurance exemption should not be allowed with respect to single premium policies taken out in conjunction with life annuities without medical examination. No published ruling has been issued, but, in the event such a ruling should be issued, it is difficult to see how it can be upheld by the U. S. Board of Tax Appeals and the courts, in the face of the broad provision in the estate tax law to the effect that proceeds of insurance, payable to a beneficiary, other than the executor or administrator, shall be excluded from the gross estate to the extent of $40,000.

There is no exception in the statute which would bar policies, whether annual premium or *single premium,* and whether *issued on a medical or non-medical basis,* and *whether or not issued in conjunction with an annuity policy.* As long as the life insurance policy comes within the true terms of an insurance policy it would seem clear that the

$40,000 exclusion from estate tax must be granted. *Insurance policies issued in conjunction with annuities are the same insurance policies that are issued separately upon a medical examination, and, until the law is changed, any denial of the exclusion would seem to be reading into the law a provision which does not exist.*" [Italics ours.]

Bowman v. Tax Com., 135 Ohio St. 395 (decided April 26, 1939). The following is quoted from paragraph 2 of the syllabus—page 295:

"2. A contract between an insurance company and a person called the assured, whereby, in consideration of a single cash premium paid by the assured to the company, a policy is issued to the assured wherein a part of the single cash premium paid is allotted to life insurance on the life of the assured, and a part of such single cash premium is allotted to an annuity contract, with a guarantee that upon settlement there will be paid to the assured, or in case of his death to his beneficiary, a sum approximately equal to the original cash premium, and in addition a monthly annuity during the life of the assured or until settlement, plus such dividends as may be allotted by the company out of its surplus interest earnings on such contract, *is a divisible insurance and annuity contract, the insurance feature of which is exempt from taxation;* * * *" [Italics ours.]

POINT II.

The Two Premiums Paid by the Insured Purchased Separate and Distinct Life Insurance and Annuity Contracts, Respectively, and These Premiums Cannot Be Construed as a Lump Sum Deposited With the Company for Investment Purposes.

The facts do not support the Commissioner's contention that the company merely received a lump sum for investment purposes. Such a finding could only be reached by substituting a pure fiction for the specific terms of the contracts, the clear intention of the parties, and the separate manner in which the respective premiums were treated. The Tax Board said in its Opinion (R. 23):

> "In the instant proceeding we think the agreement between the decedent and the insurance company as evidenced by the two documents, the insurance policy and the annuity contract, shows an intention on the part of the contracting parties to enter into an insurance and annuity contract with clearly severable features as to each, *rather than a contract of trusteeship with no separate features.*" [Italics ours.]

And again the Tax Board said (R. 23):

> "* * * Attention is called to these features in order to show the clear separability of the two contracts notwithstanding that they were taken out as parts of one transaction. *The writings did not take the form of any declaration of trust. No provision was made for any compensation to be paid the insurance company as trustee.*" [Italics ours.]

As one of the members of the Tax Board ably states in his concurring Opinion (R. 27):

"* * * Nor is it material in this case that the insurance company executed a life insurance contract in conjunction with an annuity contract. Insurance companies sell many types of insurance which combine life insurance with other benefits such as annuity payments. Such policies have various names, such as endowment policies. In the instance before us, the insurance company executed two policies, one an annuity policy. To the insurance company, there were two contracts having separate terms and separate benefits. Upon the death of the insured the annuity contract terminated and nothing passed under this contract to decedent's beneficiary. May we go outside the terms of executed contracts fully performed and decide the question as though the parties had executed a different contract or contracts? I believe we may not do so, at least where the contracts are bona fide."

In the case of *Bodine v. Commissioner,* 103 F. (2d) 932, although the premium paid was on a single annuity contract with death benefit, the Court held (Syl. 7, page 982):

"A life annuity policy with death benefit, for which applicant paid a single premium, and which entitled him to monthly payments until death or surrender of policy in return for payment of principal sum, could not be regarded for income tax purposes as a contract providing merely for deposit of a fixed principal sum payable to depositor on demand or at death with a guaranteed return of a certain percent."

Respondents therefore insist that what the insured paid and what the company received for the two separate policies were two separate premiums, one for the life insurance and the other for the annuity. This is in

accordance with the unequivocal terms of the contracts, the intention of the parties, and the company's allocation of the premiums themselves.

POINT III.

There Was a Risk to the Insurance Company in Issuing the Insurance Policy, and the Annuity Did Not Eliminate the Risk.

As the facts are undisputed as to what was done between the parties and as to the specific terms of the policies, and inasmuch as the premiums clearly state what sums the company received from the insured for the policies, and the policies show what payments to the insured or her beneficiary were to be paid thereunder by the company, the question of whether the company had a risk or not is undoubtedly one of fact and not one of law.

The Tax Board in its "Findings of Fact" (R. 14, 15) found that the company did have a risk of loss. The following are quotations from said Findings of Fact:

> "The company accepted in lieu of a medical examination the issuance of the life annuity contract, through which the company reduced but did not entirely eliminate its risk against loss due to premature death." (R. 14)
>
> "The requirement of the annuity contract as a condition precedent to the issuance of the insurance policy was due to the amount of risk involved, namely, the difference between the consideration and the death benefit. * * *
>
> The above total charge of 106 percent was later found to be unprofitable, at which time the charge was increased to 110 percent, and still later the issu-

ance of an insurance policy like the one in question was made conditional upon a medical examination." (R. 14)

The Tax Board found in its Findings of Fact (R. 14), without figuring any profit and without allowing anything for overhead expense, that the insurance company s actual expense for commission, expense allowance to general agent, and premium tax on the two policies totaled $1,475.97. Your petitioners do not agree that the two separate premiums can be properly or lawfully lumped together, but even if this were done, they only amount to $1200.00 more than the $20,000 face amount of the insurance policy. Accordingly, if the insured had died prematurely, prior to life expectancy, within a few days after taking out the two policies, the insurance company upon paying the $20,000 face amount of the life insurance would have had an out-of-pocket loss of $275.97 *in addition to the loss of general overhead expense and the loss of any profit.*

Insurance companies are conceded to have the right to charge premiums at a rate which will enable the earning of a reasonable profit, as well as cover general overhead costs and actual out-of-pocket expenses. Therefore, if a company receives such insufficient premiums (even under the false lump sum theory) from a life insurance policy and an annuity policy taken out the same day so that in the event of the premature death of the insured the company not only fails to make a profit and collect its general overhead expenses but, in addition, has to pay but almost $300 in cash more than the premiums received, there is obviously the risk of such a premature death assumed by the company in writing the life insurance policy, and the annuity policy does not eliminate it.

Your petitioners do not agree that the two separate premiums for the insurance and annuity policies, respectively, can be properly or lawfully lumped together, and on the contrary insist that the two premiums must at all times be considered separately and independently. Nevetheless, the above arithmetical calculation, taken from the Tax Board's Findings of Fact, (R. 19, 20), serves as just *one* illustration of how the insurance company, even under the lump sum theory, had a risk of loss due to premature death prior to the life expectancy. Other illustrations could be given as to the risk in case the insured had surrendered the insurance policy for its cash surrender value and yet continued to receive the annuity payments.

But to appreciate all the elements of risk involved in insurance requires a complete understanding of the complicated science of insurance underwriting. What is an insurable risk differs from time to time, from amount to amount, from individual to individual, and even between various companies. It is customary for companies to write insurance of different types without the requirement of a medical examination up to certain amounts. Even when a medical examination is required and successfully passed, companies will not write more than up to a limited sum on one individual, and even then when the amount they do write exceeds a certain figure, the excess is often underwritten with other companies, even without the insured's knowledge.

Some companies refuse to insure those engaged in certain hazardous occupations as constituting too great a risk, while other companies readily insure them. Some even refuse to insure women, while others have no such hesitation and even ccept so-called "sub-standard risks" at increased premiums. But despite the good or poor risk of any type of policy, a company may desist writing any more of that type merely in order to preserve a

proper balance or diversification of risks. In fact, all insurance involves a balancing of risk, and this is often accomplished by spreading the risk and coverage over a number of policies of various types so as to obtain the proper actuarial average and thus neutralize and, in fact, eliminate the risk on the total policies written. It is only such an elimination of risk that enables insurance companies to continually earn profits and distribute dividends.

As has been stated and as the above mathematical calculation illustrates, the question of whether the insurance company in the case at bar had a risk is one of fact and not one of law. In support of the Tax Board's finding that there was a risk there is an abundance of substantial evidence, and there is no evidence to the contrary. This clearly appears not only by the foregoing calculation but also from the following quotations from the "Statement of Evidence" (R. 41-69):

(R. 53-54)

F. J. Stevenson (an officer of the Equitable Company's general agent)—Direct.

"* * * The issuance of that contract on the same date as the insurance and execution of the life insurance policy did not eliminate the risk. When I say 'hedging it' I mean instead of eliminating it, it reduced the risk.

* * * * * *

'Q. Now, it is stated in the opening statement, that the Equitable Company had no risk. Was this policy found profitable, a life insurance policy of this type, where an annuity policy was a condition precedent, was that found so profitable to the company that it continued it?

A. It was not profitable. The basis on which we issued those policies was changed so

that instead of their having been collected as $600.00, as was the case here, or, rather, $1200.00, the amount was raised to $2000.00 subsequently, and then later the issuance was made conditional upon medical examination.'

I believe those changes were required in the increasing of the premium and in the requirement of physical examination because the company had too great a risk in the method they had operated at the time of these two policies."

The Tax Board having resolved in the affirmative, the question of whether the insurance company had a risk in writing the life insurance policy in the case at bar, and there being substantial evidence to sustain this Finding of Fact, the Circuit Court had no other alternative than to accept such finding.

Helve ing v. Kehoe, 84 U. S. L. Ed. (Advance Reports) 498 (1940):

"Upon review the court may not substitute its judgment of the facts for that of the Board. When there is substantial evidence to support the conclusion of the latter this must be accepted."

Helvering v. Rankin, 295 U. S. 123 (79 L. Ed. 1343). Opinion by Mr. Justice Brandeis at page 131:

"Fourth. The Court of Appeals is without power, on review of proceedings of the Board of Tax Appeals, to make any findings of fact."

Not only must the courts accept the Tax Board's findings of fact, when supported by substantial evidence, but in considering whether the substantial evidence sustains such findings and if they have been resolved in the taxpayer's favor, the Court must assume that all facts that the evidence of the taxpayer *tends to*

prove are established, and *all inferences fairly deducible from such facts must be drawn in the taxpayer's favor.*

Helvering v. Johnson, 104 F. (2d) 140 (June 1, 1939), opinion at page 141:

> "The issues of fact having been resolved by the Board in the respondent's favor, the question before this Court is whether the ultimate finding of the Board is sustained by substantial evidence. In considering that question we think that *all facts that the respondent's evidence reasonably tends to prove must be assumed to be established and all inferences fairly deducible from such facts must be drawn in his favor,* and that effect must be given to the rule that issues depending upon the credibility of witnesses and the weight of evidence are to be decided by the triers of the facts." [and see the several cases cited] [Italics ours]

The Circuit Court, refusing to accept the finding of the Tax Board that the insurance company did assume a risk in the writing of the life insurance policy, and in order to make contrary findings, resorted to certain mathematical calculations not properly applicable to the facts in the case. If, during the hearing before the Tax Board, such calculations had been offered in evidence by the Commissioner, the taxpayer would have had an opportunity to rebut them and show their fallacies and inaccuracies in their application to the case at bar. In its opinion (R. 73), the Circuit Court says:

> "* * * The obligation of the borrower may be divided into a complete annuity of $2 combined with a whole life insurance of $100. One merely substitutes for the ten year term a series of probabilities of being alive (annuity) and of being dead (life insurance) in the future. The relation between these converse probabilities is such that the dis-

counted sum required to provide the annuity plus that required to produce the life insurance will always be equal to the amount of the loan. We say always because the relation between the probabilities of living and dying is from the very nature of the mortality tables, on which they are calculated, constant, no matter what the age of the lender. So, an insurance company may borrow $100 at 2% from one doomed to die within ten minutes and issue in return a $2 annuity and a $100 life policy. By an actuarial tour de force (because the continuance of life is a matter of minutes, not probabilities) the amount of the loan advanced is split into the single premiums appropriate to each policy if taken out by a normal person. In other words, the sure thing (loar) is artificially separated into doubtful bet (life insurance) and hedge (annuity). It is on this general principle that an uninsurable life becomes 'insured'."

In other words, the Court added the two premiums paid on the life and annuity policies respectively, and taking this lump sum, treated it as though this sum was to remain continuously with the insurance company until decedent's death and then treated it on the basis of an investment, or in the light of an annuity. The Court, however, failed to take into consideration the important fact that the insured could have, during her life, surrendered the life insurance policy for its cash surrender value and then, if she had lived for more than 13 years, or past the age of 86, which is only 3 years longer than the average according to the mortality table used for annuities, (and it will be remembered her mother and grandmother both lived well into the nineties), she would have received, during the remainder of her life, her annuities notwithstanding the cancellation of the life insurance policy. Under such a situation, which was clearly possible, the calculations of the Court would be

inapplicable because the insurance company's funds would have been entirely exhausted upon the insured reaching the age of 86. We submit in the Appendix, page 38, Calculations, to fit such a situation, and an examination thereof will show that if the policy was surrendered for its cash surrender value a year after its issuance, and if the insured continued to live till the age of 95, the insurance company would have paid out more than $3400 in excess of what it had received on the premiums, including interest thereon, in addition to the company's loss of profits and any amount covering overhead.

Another error in the aforesaid calculations of the Circuit Court was its assumption that all the insurance company would pay on the life insurance policy was the principal amount of $20,000, and the fact that the company also paid annual dividends on such policies was entirely overlooked. These dividends would have amounted in ten years to between $1200 and $1500. (R. 17)

The Circuit Court was also in error in stating (R. 73):

> "* * * the relation between the probabilities of living and dying is from the very nature of the mortality tables, on which they are calculated, constant, no matter what the age of the lender."

The fact, as found by the Tax Board (R. 14), is that the standard mortality table used by the insurance company as the basis for the annuity rate for one of Mrs. Keller's age on her annuity policy has a 40% greater life expectancy than the standard mortality table used to compute the premium on her life insurance policy. Insurance actuaries have found that persons owning annuity policies live longer on the average than those not possessing such policies.

Petitioners, therefore, contend that the aforesaid calculations in the Circuit Court's opinion do not properly apply to the case at bar and are certainly insufficient to refute the finding of the Tax Board sustained by substantial evidence, that the insurance company did assume a risk even if the Court had the power to set aside such finding.

Therefore, it cannot be claimed that the life insurance policy was not a life insurance policy because there was no risk.

POINT IV.

Section 302 (g) of the Revenue Act of 1926, as Amended, Uses the Term "Insurance" in Its Legal Sense and With Its Contractual Aspects in Mind and Not With a View to the Economic Method Whereby the Amount Is Received.

The Circuit Court, in ignoring the legal and contractual aspects of the life insurance policy, relies upon the following two false premises: (1) that the insurance company assumed no risk; and (2) that the decedent was uninsurable. The company's actual assumption of a risk has been discussed above.

As to the allegation that the decedent was uninsurable, the authorities given therefor were a life insurance salesman's tract and the fact that no physical examination was required. Different insurance companies have different age limits beyond which they decline to write life insurance unless certain extra conditions are complied with. Suppose a company ceased writing insurance on persons over 75 years of age and later reduced the age limit to 70 but provided that those above that age seeking insurance be required to take out an annuity policy, as in the case at bar, in lieu of a physical examina-

tion. In these days of increased longevity, due to improving health conditions and the rapid medical progress in discovering new preventatives and cures, the annuity policy might be considered by the company a safer means of reducing or partly hedging its risk in the event of death than a physical examination. Certainly because the annuity policy was required as a condition precedent to issuing a life insurance policy instead of a physical examination, this would not justify the conclusion that the applicant was uninsurable.

There are many kinds of life insurance written by companies wherein a physical examination is not required. If an individual who, because of high blood pressure or some other physical defect, should hesitate to apply for a type of life insurance requiring a physical examination lest he be rejected and should obtain one of these other types of policies wherein a physical examination was not demanded, and in lieu thereof some other condition precedent required (*i.e.* group insurance), that would not justify a contention that the individual was uninsurable and therefore the policy obtained by him was an investment instead of insurance. In fact, if the decedent in the case at bar was uninsurable and the Equitable Company considered her as such and nevertheless accepted from her what purported to be on its face a premium for life insurance, whereas the funds were really received merely for investment purposes, the company would be violating the insurance laws of every state wherein they sold such policies. Such a violation should not be presumed.

In its opinion, the Circuit Court says (R. 74):

"We think the question turns upon whether the adverbial phrase 'as insurance' refers to the legal, or to the economic method, whereby the amount is received. The legal mechanism employed at bar is

> unquestionably a contract of life insurance. * * * It is plain in our estimation that the Congress used the word 'insurance' with the economic rather than the purely contractual aspects of the term in mind."

The Circuit Court admits that according to its legal significance and from its contractual aspects, the life insurance policy "is unquestionably a contract of life insurance."

We do not know from what source the Circuit Court concluded that the Congress used the term insurance with the economic rather than the purely contractual aspects of the term in mind. In fact, an examination of the Comments by the Ways and Means Committee in its Report on the 1918 Revenue Bill will show the opposite intention from that assumed by the Court below.

The history of Section 302 (g) of the Revenue Act of 1926, as amended, is as follows. Under the 1916 Revenue Act, no insurance proceeds were taxed. Section 402 (f) of the 1918 Revenue Act (40 Stat. 1057) for the first time included in the gross estate for taxation purposes amounts received by the executor and also amounts over $40,000 received by other beneficiaries. It is interesting to note that among the comments by the Ways and Means Committee in its Report on the 1918 Revenue Bill appears the following on page 22 of House Report 767, (65th Congress, 2d Session):

> "Agents of insurance companies have openly urged persons of wealth to take out additional insurance payable to specific beneficiaries for the reason that such insurance would not be included in the gross estate. A liberal exemption of $40,000 has been included and it seems not unreasonable to require the inclusion of amounts in excess of this sum."

The same statement appears in Report No. 617 of the Senate Finance Committee, 65th Congress, 3rd Session, page 42.

It is, therefore, apparent that Congress in enacting the provision exempting $40,000 of insurance taken out upon the life of the decedent and payable to a named beneficiary had in mind its application, and expected it to apply, even in the case where a wealthy person took out the insurance with the motive of decreasing his estate tax. The Circuit Court incorrectly assumed that the only purpose of Congress in enacting the exemption was to encourage wage earners or those of moderate means in rescuing their beneficiaries within the family circle from want.

The above quoted comments by the Ways and Means Committee in its Report on the 1918 Revenue Bill refute this assumption. Moreover, it is not the individual of moderate means and the wage earner who are chiefly interested in reducing estate taxes, but in view of the specific exemption of $40,000 allowed gross estates before any Federal estate tax is payable, it is chiefly those of means who are interested in decreasing their estate taxes. Accordingly, the exemption was enacted with the knowledge and intention that it would be utilized by any to whom it was available.

Not only was it clearly the intention of the Congress that the $40,000 exemption should apply to all kinds of life insurance and irrespective of the age or the financial condition of the insured but this was also the intention of the Treasury Department.

Treasury Regulation 80 (1937 Ed.) Article 25 (U. S. C. A., Title 26, Sec. 411):

"Art. 25. TAXABLE INSURANCE — The statute provides for the inclusion in the gross estate of

insurance taken out by the decedent upon his own life, as follows: (a) All insurance receivable by, or for the benefit of, the estate; (b) all other insurance to the extent that it exceeds in the aggregate $40,000.

The term 'insurance' refers to *life insurance of every description,* including death benefits paid by fraternal beneficial societies, operating under the lodge system. * * *" (Italics ours)

If the decision of the Circuit Court should be affirmed and the Supreme Court of the United States should permit the clear legal and contractual aspects of insurance policies to be entirely disregarded and the economic effects of policies substituted therefor, then practically all types of insurance contracts would lose their contractual and legal significance and could be interpreted as investments according to whatever economic theories various courts might espouse. Several books by authoritative writers have treated insurance as investments.

"Life Insurance as Investment, Life Insurance: Its Economic and Social Relations", by Solomon S. Huebner and David McCahan (1933) states in the beginning of its preface as follows:

> "The purpose of this volume is twofold, namely, (1) to show the creative force of life insurance in the accumulation of personal estates through systematic thrift and sound investment, and (2) to explain the nature of the life insurance investment, its exceptional quality by way of solvency and investment return, and its convenience and serviceability as judged by all of the other attributes used in selecting sound investments."

If courts can ignore the legal and contractual aspects of life insurance contracts and substitute therefor whatever various economic theories ingenious minds might devise, then single premium policies, twenty-year or thirty-year endowment policies, and even straight ordinary life policies might be looked upon as investments to take effect after death. Even the ordinary yearly premium life policy becomes paid-up insurance after approximately 17 years if the insured takes it out even at as late an age as 65 and allows the annual dividends paid by the company to accumulate.

Bouvier's Law Dictionary, Baldwin students' edition, defines "law" as:

> "That which is laid down; that which is established. A rule or method of action, or order of sequences.
>
> "The rules and methods by which society compels or restrains the actions of its members."

Law is based upon precedent and although it changes from time to time, it nevertheless gives to individuals and business a reasonable guide for entering into contractual obligations. Theories of economics, however, not only vary from time to time, but two or more schools can often be found existing at the same time adopting varying or even diametrically divergent theories with the resultant opposite conclusions.

If the legal and contractual aspects of life insurance contracts can be ignored and the economic effect thereof or resulting thereunder can be substituted therefor, what is to prevent the same procedure from being followed with regard to any other contractual obligation or agreement? Such a course would leave society and business subject to whatever theory of economics the court reviewing or interpreting the contract at the time might

favor and would deprive contracting parties of the guidance and security of legal precedents and sound decisions of our courts throughout the past generations. Your petitioners accordingly contend that Congress did not use the word "insurance" with an economic rather than the contractual and legal aspect of the term in mind, that the clear legal and contractual aspects of the life insurance policy in question cannot be ignored and must be considered, and that in so doing the policy in question is one of life insurance within the exemption relied upon and its proceeds are not includible in the decedent's gross estate.

CONCLUSION.

The $20,030.43 can not be taxed because it is insurance received by the decedent's daughter, beneficiary under the life insurance policy taken out by the decedent upon her own life, and Section 302 (g) of the Revenue Act of 1926, as amended, exempts such insurance up to $40,000. Therefore, the opinion of the Circuit Court should be reversed and the opinion of the Tax Board should be affirmed.

Respectfully submitted,

FERDINAND T. WEIL,

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Attorneys for Estate of Anna M. Keller, Pius P. Keller and Marcella V. Keller, Executors, Petitioners.

APPENDIX.

Revenue Act of 1926, c. 27, 44 Stat. 9, as amended by Section 803 (a) of the Revenue Act of 1932, c. 209, 47 Stat. 169, and by Sections 401 and 404 of the Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 302. The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible wherever situated, except real property situated outside the United States—

(a) To the extent of the interest therein of the decedent at the time of his death;

* * * * * *

(c) To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death, or of which he has at any time made a transfer, by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom; except in case of a bona fide sale for an adequate and full consideration in money or money's worth. Any transfer of a material part of his property in the nature of a final disposition or distribution thereof, made by the decedent within two years prior to his death without such consideration, shall, unless shown to the contrary, be deemed to have been made

in contemplation of death within the meaning of this title.

(d) (1) To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power in contemplation of his death, except in case of a bona fide sale for an adequate and full consideration in money or money's worth.

* * * * * *

(g) To the extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life.

* * * * * *

(U. S. C. A., Title 26, Sec. 411.)

Article 25 of Regulation 80 (1937 Ed.):

Art. 25. TAXABLE INSURANCE—The statute provides for the inclusion in the gross estate of insurance taken out by the decedent upon his own life, as follows: (a) All insurance receivable by, or for the benefit of, the estate; (b) all other insurance to the extent that it exceeds in the aggregate $40,000.

The term "insurance" refers to life insurance of every description, including death benefits paid by fraternal beneficial societies, operating under the lodge system. * * *

CALCULATION

An example of possible risk of loss to insurance company under Commissioner's lump-sum theory if the insurance policy were surrendered after the first year for its cash value.

Received by insurance company:

Net amount received by insurance company on annuity premium (after deducting commission and expense allowance to general agent)		$ 3,127.87
Interest on above amount at 4% for one year		125.11
Net amount received by insurance company on insurance premium (after deducting commission, expense allowance to general agent, and premium tax)		16,596.16
Interest on above amount at 4% for one year		663.45
Total amount in hands of insurance company at end of one year		$20,512.59

Paid by insurance company:

Annuity for one year	$ 390.84	
One year's dividend on insurance policy	122.60	
Cash surrender value of insurance policy	16,280.00	
Total amount paid by insurance company by end of first year		$16,793.44

Cash on hand at end of first year.....	$20,512.59
Cash paid out by insurance company by end of first year.....	16,793.44
Balance in company's hands for payments of future annuities after end of first year.....	$ 3,719.15

Adding to the amount of cash the company would have on hand at the end of each year 4% interest for each year, and subtracting therefrom the $390.84 annuity obligated to be paid by the company each year, would show the following amounts in the hands of the insurance company for the successive years after the cancellation of the policy as follows:

Year	*Age of Insured*	*Surplus*	*Deficit*
2nd		$3477.08	
3rd		3225.32	
4th		2963.50	
5th		2691.20	
6th		2408.01	
7th		2113.49	
8th		1807.19	
9th		1488.64	
10th		1157.35	
11th		812.80	
12th		454.47	
13th	87		$ 305.76
14th	88		696.60
15th	89		1,087.44
16th	90		1,478.28
17th	91		1,868.56
18th	92		2,259.40
19th	93		2,650.24
20th	94		3,041.08
21st	95		3,431.92

It will be noted that after the insured reaches the age of 86, the company sustains a loss each year thereafter from $305.76 at the insured's age of 87 to $3,431.92 if the insured should live to the age of 95. Furthermore, the above calculations figure the 4% interest on the amount in the hands of the company for the entire year without taking into consideration the fact that the annuities are paid semi-annually, and also inferring that the company would earn 4% interest on its funds instead of 3½% — the Tax Board's finding of fact being that the insurance company's earnings on its own funds range from 3½% to 4% (R. 17). It should also be noted that in addition to the monetary loss the company would also not receive during all these years any amount to apply on its overhead charges or profits.

Similar calculations could be made in the event of the cancellation of the policy and its being surrendered for its cash surrender value during its second, third, fourth or subsequent years.

In the event the Commissioner should claim that the above risk or loss arises out of the annuity contract and not by virtue of the insurance policy, the following should be noted: It is only by attempting to look at the two contracts as merged into one and by lumping the two premiums into one sum, which sum would be available for payments under both policies, that gives any color whatsoever to the Commissioner's claim that the company assumed no risk. Obviously, if the premiums were not so lumped together and if the insured died within a few years after the issuance of the life insurance policy, and the company could not add to the premium on this policy the premium received on the annuity policy, the company would sustain a loss on the life insurance policy. Therefore, it is not logical on the one hand to treat the two policies as combined and the two premiums as one lump sum, and then, on the other hand, if the insured lived for a number of years to then seek to separate the policies and the premiums and claim that the loss is only by virtue of the one contract.